

February 26, 2001

Governor Bob Holden
Office of the Governor
State Capitol Building, Room 216
Jefferson City, Missouri 65101

Re: Report on inquiry into the price spike of natural gas

Dear Governor Holden:

On January 24, 2001, you asked me to look into the dramatic natural gas price spike that has created hardship for many Missouri consumers. This letter constitutes my findings.

My office conducted an inquiry which included public hearings in Kansas City on January 31, 2001, and in St. Louis on February 9, 2001. Both Laclede Gas Company and Missouri Gas Energy attended the hearings and I am pleased to report both have subsequently requested price adjustments which will provide some relief to consumers.

Our investigation did not uncover any illegal activity associated with Missouri laws governing gas price regulations. Rather, it uncovered what Missouri ratepayers may have already surmised from their gas bills - that Missouri law regulating the pricing of natural gas is itself broken. I urge the administration to work with the legislature and/or the Public Service Commission to implement both short term and a long term fixes to the way Missouri regulates the retail pricing of natural gas. Our system should appropriately balance the consumers' interest in low prices, the ability of the regulators to protect consumers from dramatic rate increases, and the companies' legitimate interest in maintaining a reasonable rate of return.

Currently, the mechanics of retail pricing place the entire burden of natural gas price volatility on the shoulders of residential and small business ratepayers. The system now allows local distributing companies regulated by the Public Service Commission to pass on their wholesale costs for natural gas directly to their ratepayers as a component of each ratepayer's bill. Each local distributing company can file purchase gas adjustments¹ to their rate tariffs if the wholesale market price of natural gas fluctuates. The purchase gas adjustment is not necessarily the actual price the local distributing company has paid for the gas that is then resold to consumers. The purchase gas adjustment is just an estimate based on the current wholesale price on the New York Mercantile Exchange.

The PSC allows each local distributing company an April and a November purchase gas adjustment. It also allows the local distributing company one unscheduled purchase gas adjustment if the wholesale market price increases by more than 15% or decreases by more than 10%. A gas company can file a purchase gas adjustment which the PSC will adjudicate approximately ten days after its filing. In other words, retail rates can go up based on an estimate of wholesale natural gas price in just ten days. But the "true up" or rate adjustment based on the actual wholesale cost of the natural gas through-put to ratepayers does not occur until after the PSC has undertaken an "actual cost adjustment" proceeding, which can be anywhere between nine months, or, if contested, a few years.

In addition, regardless of the accuracy of the price estimated in the purchase gas adjustment filing, the actual wholesale purchase costs are not subject to a prudence review until well after consumers have paid bills containing the estimated wholesale price. In conducting the prudence review, the PSC examines whether a company's natural gas procurement practices, including hedging practices (physical and financial), were prudent at the time they were undertaken.

In the short run, Missouri ratepayers could benefit from legislation designed to guarantee that the component of rates Missourians pay for natural gas based on wholesale gas prices goes down as quickly as it can go up, subject to penalties imposed on the companies and direct credits to customers' bills. That kind of benefit will not completely insulate Missouri ratepayers from wholesale price volatility, but it will at least compel the companies to share some burden of that volatility.

Also in the short run, Missouri ratepayers could benefit from legislation that removes the cloak of confidentiality that currently hides the actual wholesale price a company pays for natural gas and the volume of gas purchased at that price. That information is deemed "highly confidential" by the companies and protected from public disclosure by the Public Service

¹ Notwithstanding the general prohibition on single-issue rate making, purchase gas adjustments are considered lawful by virtue of an appellate decision in *State ex rel. Midwest Gas Users' Association, et al., v. Public Service Commission*, 976 S.W.2d 470 (Mo. App. W.D. 1998).

Commission through section 386.480, RSMo. Because of that confidentiality restriction, ratepayers are asked to believe that they are buying gas whose price is passed through on a dollar-for-dollar basis with what their natural gas company paid. But in actuality, consumers have no way of knowing whether the gas they just used was purchased last summer at (for example) \$2.53 per Mmbtu's or in January at \$9.97 per Mmbtu's. If companies are not allowed to profit one dime from the actual price of gas, as is the theory under Missouri's current regulation, and the cost is completely passed on to consumers, there is a need and a justification for complete transparency in the information available to consumers about the price they are paying for the actual gas they are using.

Finally, I suggest that the administration undertake long-term analysis at restructuring the way Missouri regulates the retail distribution of natural gas. Right now, we are essentially using a 1960's regulatory model to regulate the distribution of natural gas to consumers at the retail level. This winter's price spike shows that the system does not work well. The wholesale market was deregulated by federal legislation in 1989 by unbundling production from transportation and distribution. The retail market is still a series of regionally demarcated monopolies. Residential and small business consumers have no choice of supplier for natural gas, yet, they bear 100% of the risk of price fluctuations.

The current system of regulation places no real incentives on local distributing companies to mitigate the wholesale price of gas they pass on to their "captive" ratepayers, or to cut costs to price more competitively. The retail suppliers, on the regulated side of their natural gas business, earn a fixed return calculated on the cost of service and a volumetric return based on the amount of gas consumers use. Regulation models based on traditional notions of supply and demand do not work well because of the monopolistic character of natural gas distribution and because, while natural gas may be a commodity with fluctuations in demand, heat is not. Heat is a basic necessity. The sustainability of human life places the "demand" for heat within very narrow, inelastic boundaries. Moreover, the volumetric component of regulating retail natural gas distribution provides no real incentive for conservation of a non-renewable natural resource.

Areas of review for possible long-term solutions should include:

- The current Purchase Gas Adjustment program which allows companies to file for rate changes three times a year, based on wholesale gas price changes as reported on the NYMEX;
- The possible use of the standard rate-making process, which requires the company to justify all of its costs, including gas purchases, prior to approval;
- Consideration of a possible split between gas costs passed through to the consumer through the PGA and placing some portion of the gas cost in the general rate case for an audit of reasonableness of the costs;

■ Reevaluation of the current incentive programs. The state should consider whether the ratepayer should be assuming total risk in the program, which allows industry to absorb a portion of the profit;

■ Allowing industry to recover fixed distribution costs on a monthly basis rather than through volumetric charges. The current system requires consumers to pay a substantial portion of those costs during high heating bill months;

■ Unbundling or some other form of “deregulation” that provides consumers the opportunity to choose which gas supplier they would like to supply the commodity.

Changing the regulatory model for the retail distribution of natural gas, and in particular, its pricing, will involve hard choices of public policy on the part of both your administration and the legislature. There is no model that will satisfy everyone, but the model currently in place loads all the burden of price volatility and conservation on consumers.

The transcripts of our hearings and other pertinent information are attached and may be of value to the Public Service Commission and to your energy task force. I stand ready to provide any additional assistance, should you so desire. I commend you for taking every effort to address this important issue.

Sincerely,

Jeremiah W. (Jay) Nixon
Attorney General